Blevins v. Commissioner, T.C. Memo. 1975-208

A reduction in a taxpayer's ownership interest in a corporation formed from a partnership, after a tax credit was claimed on partnership assets transferred to the corporation, triggers investment tax credit recapture, even if the assets remain in the same business.

Summary

W. Frank Blevins, initially a partner in Franklin Furniture Co., received investment tax credits in 1965 and 1966 based on partnership property. The partnership incorporated in 1966, becoming Franklin Furniture Corp., and Blevins retained the same proportional ownership. In 1968, Blevins gifted a portion of his corporate stock, reducing his ownership from 45% to 21%. The IRS sought to recapture a portion of the previously claimed investment tax credits. The Tax Court held that the stock gifts triggered recapture because Blevins' reduced corporate ownership, derived from his partnership interest, fell below the threshold for maintaining a 'substantial interest' under relevant tax regulations, despite the underlying assets remaining in the same business.

Facts

1. From December 1, 1965, to December 31, 1966, W. Frank Blevins owned a 45% interest in Franklin Furniture Co., a partnership.
2. The partnership acquired new and used Section 38 property during this period.
3. Blevins received investment tax credits based on his share of this property in 1965 and 1966, which reduced his tax liabilities for 1962, 1963, and 1965.
4. On December 19, 1966, Franklin Furniture Corp. was formed to succeed the partnership.
5. The partnership's assets, including the Section 38 property, were transferred to the corporation as of December 31, 1966, in a Section 351 tax-free exchange.
6. Blevins received 112.5 shares, or 45%, of the corporation's stock, mirroring his partnership interest.
7. On July 1, 1968, Blevins gifted 30 shares of stock to each of his two sons, reducing his corporate ownership to 21%.
8. As of the gift date, the Section 38 property had been in use for less than four years, which was within its estimated useful life for credit purposes.
9. The corporation retained the Section 38 property and had not disposed of it by December 31, 1968.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in W. Frank and Henrietta Blevins' 1968 income tax due to the recapture of prior years' investment credits. The Blevins petitioned the Tax Court to dispute this deficiency.

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Issue(s)

1. Whether the gifts of stock in Franklin Furniture Corp. by W. Frank Blevins in 1968, which reduced his ownership from 45% to 21%, triggered a recapture of 53.33% of the investment tax credits he had claimed in 1965 and 1966.

Holding

1. Yes, the gifts of stock triggered recapture because Blevins' reduced ownership interest in the corporation, derived from his original partnership interest, resulted in a failure to maintain a 'substantial interest' in the business for investment tax credit purposes under applicable regulations.

Court's Reasoning

The court reasoned that Section 47(a)(1) of the Internal Revenue Code requires recapture of investment credits if property is disposed of or ceases to be Section 38 property before the end of its useful life. While Section 47(b) provides an exception for a 'mere change in the form of conducting the trade or business' if the taxpayer retains a 'substantial interest,' this exception is not absolute.

The court referenced Treasury Regulation §1.47-3(f)(5)(iv), which directs taxpayers to partnership recapture rules (§1.47-6(a)(2)) when there is a reduction of interest after a change in business form. The court interpreted this regulation to mean that even if a 'substantial interest' is initially maintained after incorporation, a subsequent reduction in that interest can trigger recapture if it falls below certain thresholds outlined in partnership recapture rules. Although neither party contested whether 21% constituted a 'substantial interest,' the court proceeded with the recapture analysis based on the existing regulations.

Applying Regulation §1.47-6(a)(2), the court found that Blevins' reduction in ownership from 45% to 21% constituted a 53.33% reduction of his original partnership interest. Because this reduction exceeded the permissible limits under the regulations for maintaining investment tax credits, recapture of 53.33% of the previously claimed credits was warranted. The court rejected the petitioner's argument that recapture only applies if the corporation disposes of the Section 38 property, emphasizing that a reduction in the taxpayer's interest in the business also triggers recapture under the regulations.

Practical Implications

Blevins v. Commissioner clarifies that the 'mere change in form' exception to investment tax credit recapture is not a permanent shield. Attorneys and tax advisors must consider not only the initial incorporation or change in business form but also any subsequent changes in ownership interest. Even if Section 38 property remains within the same business, a significant reduction in the taxpayer's ownership, through gifts, sales, or other means, can trigger recapture. This case

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highlights the importance of ongoing monitoring of ownership percentages in pass-through entities and successor corporations that have benefited from investment tax credits. It emphasizes that tax planning for investment credits must extend beyond the initial investment and consider future ownership changes to avoid unexpected recapture events. The case also underscores the Tax Court’s reliance on specific Treasury Regulations to interpret and apply broad statutory provisions like Section 47.

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